Financial Services Taxation

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I. Introduction.[1]

A. In the past, federal law (the Glass-Stegall Act) had prevented companies in the securities, bank and financial, and insurance industries from simultaneously operating in the same affiliated group of corporations. As a result, the state income tax laws that provide for apportionment of income have tended to develop apportionment rules for each industry type independently of the others. The Financial Services Modernization Act of 1999 (Graham-Leech-Bliley) now permits corporations engaged in all three industry types to be simultaneously held by a common parent holding company. This presents significant potential for such corporations to constitute members of a single unitary business for purposes of the apportionment rules under various state income tax laws.

B. Apportionment of business income. If a corporation conducts its activities in more than a single state, most states with an income tax divide the total business income of the corporation between the respective states by apportioning that income. The apportionment percentage used typically is a composite of ratios ("factors"), determined by comparing the amount of property, payroll, or sales in the tax state to the property, payroll, and sales in all states.[2]

C. Unitary businesses. It is not uncommon for a single corporation to have two or more trades or businesses operating within it. Thus, it is a frequent inquiry in apportioning states whether two or more business segments represent separate apportioning trades or businesses, or a single trade or business. A single trade or business is referred to as a "unitary business." A number of tests have emerged to determine whether the business segments are separate businesses or are parts of a unitary business. For

[1] The comments in this paper are those of the speaker and do not necessarily represent the views of his employer.

[2] See the more detailed discussion of apportionment, below.

example, the U.S. Supreme Court inquires as to whether the business segments have "functional integration, centralization of management, and economies of scale."[3]

D. Combined reporting. In some cases, a group of two or more corporations operating under common ownership[4] can also constitute a unitary business. A number of states, known as "combined reporting states," permit or require combination of the business income of those corporations in a common pool of income subject to apportionment.[5] The combined business income of those corporations is apportioned to the taxable corporations doing business in that state, reflecting each taxpayer member's share of total business income of the group. That apportionment (sometimes described as "intrastate apportionment") reflects the component contribution of the each of taxpayer members' property, payroll, and sales in the apportionment formula used to apportion the income of the group.

E. Scope of Combined Reporting. In a number of states where the combined reporting principle is applicable, unitary combined reporting treatment is mandatory.[6] If the concept of mandatory combination is applied to all three business types in the financial services industry (or if a state permits or requires that combination), then the separate rules of apportionment of income for each industry type, must make an accommodation to the unitary business principle, despite the apportionment difficulties presented in the combination. Those difficulties are discussed below.

II. How Likely is Unitary Combination under Deregulation?

A. How likely is it that banks, financials, securities businesses, and insurance businesses, now operating under common ownership, will exhibit unitary characteristics? Traditional unitary ties include intercompany sales, transfer of technical or business information, common trade names, common advertising, common purchasing, common customers, common sales force, common distribution systems, common financing, transfer of management personnel, strong central management and central departments, etc. Does the financial deregulation environment permit these traditional ties to come into existence?

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[3] *Container Corporation of America v. Franchise Tax Board* (1983) 463 U.S. 159. The common indicators that show the existence of a unitary business will be discussed below.

[4] Common ownership generally refers to a group of corporations, or chains of corporations, where more than 50% of the voting stock of the members is owned either by a parent corporation or an individual. See, e.g., Section 25105, Cal. Rev. and Tax Code; MTC Reg.IV.1.(b)(4).

[5] E.g., *Edison California Stores v. McColgan* (1947) 30 Cal.2d 472.

[6] E.g., *Superior Oil v. Franchise Tax Board* (1963) 60 Cal.2d 406; *Honolulu Oil Corp. v. Franchise Tax Board* (1963) 60 Cal.2d 417.

B. How likely will it be that the commonly owned businesses will exhibit strong central management and centralized departments?

C. Functional or operational integration. Will the commonly owned businesses be permitted to engage in use of common trade names and common advertising? Can the companies share customer lists? Can promotional materials for one business type be included in the billing statements of the other?

1. Can one commonly owned business type set up kiosks or offices within another business type's customer service area, creating, from the perspective of the customer, a "one stop financial shopping" network?

2. Do employees of one business to sell or at least market the sale of financial products of the other? Is there any regulatory limitation that would prevent a parent from directing its employees to encourage customers of one business type to utilize the services or financial products of the other business types?

3. May one business type sell instruments or services that was traditionally sold by another business type? For example, can a savings and loan sell annuities that are also sold by an insurance company? Can a bank, or its subsidiary, underwrite securities? To what extent can the various business types share business knowledge and marketing expertise?

4. What restrictions, if any, are there on the movement of funds between the various business types?

5. Assuming that a unitary relationship can exist between the members of the banking, financial lending, securities, and insurance industries, combination of these industries is likely to create significant apportionment issues.

III. Summary of the General Rules of Apportionment.

A. Most states that provide for apportionment of income utilize a formula based on or substantially similar to the Uniform Division of Income for Tax Purposes Act (UDITPA). UDITPA utilizes three ratios, or "factors:" a property factor, a payroll factor, and a sales factor. For example, the sales factor represents the ratio of the taxpayer's sales in the taxing state to its sales everywhere. Under UDITPA, the apportionment percentage is the sum of the three factors, divided by three.

B. Generally, a "sale" in the sales factor is the gross amount realized in a sales transaction, i.e. without reduction for basis or cost of goods sold.[7] For purposes of

[7] See MTC Reg. IV.2.(a).(5).

the numerator of the sales factor, a sale of tangible personal property is generally assigned to the destination of the sale,[8] while a sale of other property, or services, is assigned to the state where the greater income producing activity is located, based on cost of performance.[9]

C. The payroll in the payroll factor includes the amount paid as wages to employees, and excludes amounts paid to independent contractors. Wages are generally assigned to the numerator of the payroll factor based on the location of the state where the employee predominately performs his or her services.[10]

D. The property in the property factor includes the taxpayer's real and tangible personal property. For purposes of the numerator of the property factor, property is generally assigned to the state where it is located.[11] Under the standard rule, intangible property is not included in the property factor.

IV. Special Apportionment Rules for Banks and Financials.

A. Many states that apportion income of banks and financials provide for different apportionment rules than the standard ones, either by statute, or by application of section 18 of UDITPA, which permits the state to vary from the normal rules of apportion if necessary to properly reflect the taxpayer's activity in the taxing state. Such variations are done on an ad-hoc basis, or by regulation.[12]

B. Special rules provided for this industry are illustrated by the Multistate Tax Commission's recommended formula for bank and financials.[13]

C. The MTC's recommended sales factor[14] reduces the "amount realized" in the traditional sales factor by reflecting certain sales on a "net income" basis. For example, sales of loans, credit card receivables, investments and trading assets (e.g.,

[8] UDITPA, Section 16.

[9] UDITPA, Section 17.

[10] UDITPA, Section 14.

[11] UDITPA, Section 10.

[12] See e.g., *Crocker Equipment Leasing, Inc. v. Department of Reve*nue (Ore. 1992) 838 P.2d 552; Cal Code of Regs., tit. 18, section 25137-4.2.

[13] MTC, *Recommended Formula for the Apportionment and Allocation of Income of Net Income of Financial Institutions* (Nov. 1994), hereafter "*MTC Recommended Formula.*"

[14] *MTC Recommended Formula*, Section 3.

federal funds,[15] options, futures, swaps, foreign currency sales, repurchase agreements (REPOs),[16] etc.), are reflected on a "net" basis.

1. The inclusion of loans and credit card receivables on a net basis in the sales factor is a variation from the normal sales factor rule, which, as noted, is reflected as the "gross amount realized." This reflects the fact that banks and financial commonly sell those loans shortly after origination, and use the proceeds to make new loans. The bank often retains a relationship with its former borrower, by "servicing" the payment transaction, for which it receives a fee from the new purchaser. In those cases, most of the income that will be earned by loan origination is in loan fees, points, and loan servicing. Little income, if any, is earned on the sale of the loan itself. If loans were reflected on a gross basis, these amounts would tend to swamp loan origination fees, points and servicing fees, as well as interest earned on loans retained, and apportion a disproportionate amount of income relative to the earning capacity of the transaction.

2. Similar potentials for distortion are present in the sales factor treatment of investment and trading assets. Banks and financials typically engage in an extraordinarily high volume of such transactions (usually to maintain cash reserves), and the income earned on them tends to be quite modest.

3. The potential for distortion represented by reflecting both of these types of transactions on a gross basis, is similar to the distortion associated with sales of assets in a corporation's treasury function, which also tend to be high volume, relatively low yield sales. As in the case of treasury function assets, most of the sales activity for these transactions is concentrated in the headquarters state, and reflecting apportionment on a gross basis would tend to apportion a substantial portion of income toward a single state. Many authorities reflect treasury sales on a net basis under authority of section 18 of UDIPTA, as well.[17]

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[15] Federal funds are reserve balances at Federal Reserve Banks that depository institutions can lend to one another. The most common federal funds transaction is an overnight, unsecured loan between two financial institutions.

[16] A repurchase agreement is an agreement to sell U.S. securities, and then to repurchase them within a specified period (usually not more than seven days) at a specified amount. This is done to increase bank cash reserves on a short-term basis. The U.S. Supreme Court held that, in substance, many repurchase agreements are private party loans secured by federal obligations (*Nebraska Dept. of Rev. v. Loewenstein* (1994) 513 U.S. 123. Note that federal funds loans and REPOs would probably not be considered a "sale" in any event under the MTC definition of "gross receipts" MTC Reg.IV.2.(a)(5)(1 and 2), excluding return of principal on a loan or REPO from the definition of a "gross receipt."

[17] See, e.g., MTC Reg. IV.18.(c).(4); *Appeal of Pacific Telephone and Telegraph*, Cal. St. Bd. of Equal. 78-SBE-028, May 4, 1978; *American Telephone and Telegraph v. St. Tax Appeal Board* (1990) 241 Mont. 440.

4. These principles appear to support a proposition that not all sales in the sales factor are "created equal." Sales that have a very high ratio of amount realized to gross income earned have the potential to give rise to distortion.

5. Unlike the normal "cost of performance rule" of Section 17 of UDITPA, for purposes of the numerator of the sales factor, if a loan is secured by real property, interest on the loan is assigned to the location of the property. Otherwise, interest on a loan is assigned to the "location of the borrower," usually the commercial domicile of the borrower (if a trade or business) or the billing address of the borrower.

6. Additional special numerator assignment rules apply for loan servicing fees, credit card merchant discount, net gains on loans and investment property, etc.

D. The MTC's recommended property factor[18] includes loans (including credit card receivables). On the other hand, the property factor excludes real and tangible property acquired by foreclosure of a loan.

1. The inclusion of loans in the property factor is a variation from the normal property factor rule, which, as noted, is limited to real and intangible personal property. This reflects the fact that banks and financial corporations have an extraordinarily large part of their capital in loans, and the income generating capacity of this industry is not properly represented just by the banks' equipment, and branch and headquarters buildings.

2. For purposes of the numerator of the property factor, loans are assigned to the state where the "preponderance of substantive contacts" occurs, generally determined by the predominate activity that occurs with respect to solicitation, investigation, negotiation, approval, and administration of the loan (commonly referred to as SINAA).

E. Potential for distortion from combination of general and financial corporations. While apportionment of bank and financial income works reasonably well if the only members of the group are in that same business, problems start to emerge when a financial corporation is unitary with a general corporation.

1. For example, it is common for a general corporation to have a consumer financing subsidiary that lends to the customers of the general corporation. An example is General Motors and General Motor Acceptance Corporation. California has special apportionment rules specifically dealing with that situation.[19]

[18] *MTC Recommended Formula*, Section 4.

[19] Cal. Code of Regs. Section 25137-10.

2. In general, the special rules for financial corporations apply, except that loans in the property factor are weighted at only 20% of their value under the financial corporation rules. This prevents the financial corporation's loan portfolio from swamping the property of the general corporation in the combination.

3. This rule reflects the fact that loans of lending institutions are largely financed by the lender's own debt, typically in the form of bank deposits or other indebtedness. Thus, the income earning potential of loans tends not to be as high as assets of general corporations, such as plant, equipment, and sales offices. Thus, the net value of a loan is reflected by the debt liability against it. Banks famously make money by lending other people's money, earning money on the difference between interest earned and interest paid.

4. This rule also reflects the notion that not all items in the factors are created equal. However, the California rule only applies to certain combinations of general corporations and financial corporations. Is there an argument that a discounting of loan value should be reflected for all unitary combinations of general and financial corporations?

V. The Apportionment of Income of Securities Dealers.

A. As noted above, the standard UDITPA sales factor reflects the gross amount realized with respect a sale of an asset. Securities dealers generate a very large volume of sales of assets. Such sales usually represent underwriting receipts and principal sales.

B. Underwriting. When a large corporation, the states, or the U.S. government seek to promote the sale of their stocks or bonds, it is generally inefficient for them to deal directly with the buying public. Securities dealers purchase such instruments in bulk, and then resell them to their customers. As we understand it, generally, the ultimate seller announces the issuance, and the securities dealers' customers place orders for purchase. The underwriter only briefly holds title, and makes a small profit on the difference between its purchase price and the sales price to its customers. (Underwriters may also earn income by guaranteeing a purchase of a specific amount of a security at a set price, for which they receive a fee.)

C. Principal sales. A securities dealer can also derive receipts from the sales of securities they hold for sale to customers (so called "principal sales"), a kind of "inventory" of securities on hand.

D. Securities dealer may also derive income from brokering the purchase or sale of a security between its customer and a seller on the stock exchange. In that case, the

broker does not take an intermediate title to the security, but instead obtains a service fee for helping to consummate the transaction.[20]

E. Issues of Distortion.

1. In general, underwriting sales (and perhaps principal sales, as well) produce considerably less income for a given amount realized than do brokerage receipts.

2. In the *Merrill Lynch* case[21] the Franchise Tax Board argued that Merrill Lynch's sales factor should reflect its underwriting and principal securities sales on a net income basis rather than gross receipts. The Franchise Tax Board asserted that the use of gross receipts for these sales had the effect of distorting the taxpayer's sales factor, when that activity was compared to its brokering activity. It relied on the *Pacific Telephone*[22] case which treated gains in the taxpayer's treasury function on a net income basis for sales factor purposes. The Board of Equalization stated that a mere mathematical difference between one method and another was not by itself proof of distortion and the Franchise Tax Board provided no other proof of distortion. In addition, because underwriting and securities sales were part of Merrill Lynch's primary business activities (and not a mere ancillary activity), *Pacific Telephone* was distinguishable.

3. Combination of General Corporations and Securities Dealers.

   a. Notwithstanding the *Merrill Lynch* case, the Franchise Tax Board continues to see a gross disparity between the ratio of income earned by securities dealers to its receipts from underwriting and principal sales as compared to a similar ratio for general corporate enterprises.

   b. In a case still under consideration, the unitary combination of a large corporate taxpayer and its commonly owned securities dealer presents a troubling scenario. In that case, the securities dealer produced less than 5% of the combined income of the group, but produced an

[20] The states sometimes have different practices for the numerator assignment of brokerage fees than that provided in the standard cost of performance rule for services. For example, under the Franchise Tax Board's Multistate Technique Manual, ¶7800, commission fee receipts are 60% attributable to the originating office, and 40% attributable to the state of the exchange. Arguably, brokerage services are properly considered personal services, which would allocate the sale on the basis of a ratio of time spent in performing the service. See MTC Reg. IV.17.(4).(B)(c).

[21] *Appeal of Merrill, Lynch, Pierce, Fenner & Smith, Inc.,* Cal. St. Bd. of Equal., 89-SBE-017, June 2, 1989.

[22] *Supra*, at fn. 16.

enormous increase in the sales factor denominator of an approximate multiple of 25, or 2,500%.

c. As *Merrill Lynch* says, that by itself isn't proof of distortion, but it makes one wonder whether there isn't something about underwriting and principal sales that makes it likely that this industry operates on an extremely thin margin, producing very large sales and relatively little income.

4. Combination of Securities Dealers and Financial Institutions.

a. The specific effect of combination of financial corporations and securities dealers presents its own set of problems. The effect of *Merrill Lynch* with respect to securities dealers (underwriting sales and principal asset sales reflected as a gross receipt in the sales factor) could easily result in the sales factor swamping the effects of other sales of the rest of the group.

b. For example, in the case of *Appeal of Fuji Bank* (unpublished opinion, Sept. 2000), the stockbroker member of the unitary group only contributed 2.6% of the business income of the group, but under the *Merrill Lynch* holding, its underwriting and principal asset sales produced 99.6% of the sales factor denominator. It did so by increasing the denominator of the sales factor from $2.6 billion to $670 billion, a multiple of 250 times, or 25,000%.

c. Arguably, placing the bank and financial corporations sales of notes, securities, trading assets, credit card receivables, etc. on a net income basis, and the securities firms principal trading asset and underwriting receipts at gross fails to reflect the relative contribution of the respective market states for these industries. Is there a sufficient difference between a bank's loans and trading assets and the principal asset sales of a securities dealer to consider the former at net and the latter using gross receipts? Is the solution to place securities corporations gains on a net basis, or to inflate the bank's sales of financial instruments to reflect gross receipts? Would that cause other distortions with respect to the rest of the financial corporation's sales, in contravention of the rationale which put sales of loans and credit card receivables at net in the first place?

5. New York has dealt with the apportionment of income of securities dealers in recently adopted legislation, effective for years beginning January 1, 2000.[23]

[23] New York Tax Law, Article 9-A, Section 210.3(a)(9).

a. The New York statute would put underwriting receipts and principal sales in the sales factor at net profit. Thus, while California reflects large gross values in the denominator of the sales factor under *Merrill Lynch*, New York places relatively smaller amounts of net profit in the New York numerator.

b. The juxtaposition of these two rules results in a substantial amount of securities dealer's income to escape taxation in any state. That happens any time the sum of a taxpayer's apportionment percentages fail to add up to 100%. While it is certainly possible that New York's legislation was intended to provide a local subsidy to New York securities dealers, it bears inquiry whether the New York "net sale" rules were intended to alleviate New York distortion.

c. In addition, the New York legislation assigns brokering services and investment advice to the customer's billing address, which is essentially a consumer market destination rule. Most other states, in the absence of special rules under section 18, would assign such receipts to the state where cost of performance is. Whenever there is lack of uniformity, there is potential for income escaping or for double taxation. Should a state considering adoption of specialized apportionment rules for securities dealers consider adoption of the market-based rules in New York? Is that suggested by an analogy to the market-based rules for banks and financials?

6. Illinois deals with this issue broadly. By special apportionment rule, sales of all business intangibles are reflected on a net gain basis, which puts securities dealers in roughly the same position as taxpayers in New York.[24] Colorado has a similar rule.[25] Presumably, however, the numerator assignment of the net receipt remains based on cost of performance principles rather than a market-based rule.

F. Property factor issues. Securities dealers would be expected to argue that if they are properly treated as analogous to a financial corporation for purposes of the sales factor, they should obtain property factor representation for the weighted average value of intangibles held for sales to customers, on the theory that, like a bank, securities represent the predominate utilization of their capital, and are a primary means by which it makes its income.

1. Without property factor representation for securities dealers, would there be similar distortion issues created with respect to combination of financials and

[24] 86 Illinois Administrative Code, Section 100.3380(c)(5).

[25] Colo. Rev. Stat. § 39-22-30(4)(b). "[t]he gross receipts regarding the sale of intangible assets shall be the gain from the sale and not the total selling price."

securities dealers? Is it possible that, without property factor representation, a bank's loans and credit card receivables would have the effect of swamping the relatively minor real and tangible personal property of the securities dealer?

2. Why should loans of banks and margin loans of a stockbroker be treated differently?

3. If intangibles of the securities dealer are to be included in the property factor, is it appropriate to discount the property factor value of those intangibles, similar to the 20% discount in value in California's rule for combination of general and financial corporations (18 CCR §25137-10)?

4. Should banks be given representation for their trading assets in the property factor to match similar trading assets of a broker?

5. Where would the location of the intangibles of the broker be assigned? Is commercial domicile of the broker/dealer the right answer?

VI. Apportionment of Income of Insurance Companies.

A. In California, insurance companies are not subject to an income or franchise tax. Instead, insurance companies are subject to a 2.5% gross premiums tax on insurance risks underwritten in the state. The California Constitution provides that the gross premiums tax imposed on insurers doing business in the state is "in lieu" of most other taxes, including income taxes.[26] Other states have similar "in lieu" provisions, although they are typically statutory.

B. In FTB Legal Ruling 385 (1975), the Franchise Tax Board legal department held that the "in lieu" provision of the California Constitution also prevents combination of insurance companies in a combined report of a general corporation, even if the insurance company and the general corporation are unitary. It held that exempt organizations, including insurance companies, should not be subjected to combined reporting, because neither were in a class of "taxpayer" to which combined reporting applied. To balance the effects of exclusion of California insurance companies from combined reporting, the ruling also excludes insurance companies operating entirely outside of California from the combined report.

C. Most states have "in lieu" premiums tax similar to California's. Some of those states, like California, do not permit or require combination. For example, the Idaho Supreme Court held that an insurance company could not be combined with a general

[26] Article 13, §28(f) of the California Constitution; *First American Title Insurance & Trust Co. v. FTB* (1971) 15 Cal.App.3d 343).

corporation in *AIA Services Corporation v. Idaho State Tax Comm.*[27] On the other hand, the Oregon Tax Court allowed the Department of Revenue to include a unitary insurance company in a consolidated return group in *State ex rel. Dept. of Revenue v. Penn Independent Corp*.[28] A minority of states tax insurance companies on income with a credit against premiums tax paid or permit an election between premiums tax and income tax, e.g., Florida, Indiana, Louisiana, Mississippi, Montana, Nebraska, New Hampshire, Oregon, Tennessee, and Wisconsin.

D. Recently, both taxpayers and taxing agencies have explored the issue whether insurance companies should be combined with other businesses. The Multistate Tax Commission has drafted a proposed combined reporting statute that would grant a tax commissioner power to adopt regulations that could result in combination of insurance companies and general companies.[29] This proposal was recently circulated to the MTC member states for a By-Law 7 survey.[30]

    1. The insurance industry has voiced vigorous opposition to that provision.

        a. It has been argued that the intention of the "in lieu" provisions is to exempt insurance company income from the income tax base, and that combination indirectly results in apportionment of statutorily exempt income.

        b. Industry representatives have voiced additional concerns regarding some of the income and apportionment issues discussed in detail below. In addition, the insurance industry has raised concerns that combination could raise issues regarding retaliatory tax provisions common in insurance taxation in the various states.[31]

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[27] (2001) 136 Idaho 184.

[28] (1999) 15 OTR 68.

[29] The proposal is a compromise between those that would advocate combination of insurance companies in all events, and those that would bar combination completely (except for abusive situations). Providing regulatory authority to combine would also provide an opportunity to consider some of the issues discussed in this paper in a more deliberative fashion than would a per se rule.

[30] A Bylaw 7 survey asks MTC member states if they would consider adoption of the proposal. If the survey is returned positively, the full Commission considers the matter for adoption.

[31] See, e.g. Sections 685-685.4 of the California Insurance Code, which imposes a retaliatory tax on out-of-state insurers doing business in California, when the insurer's State of incorporation imposes higher taxes on California insurers doing business in that State than California would otherwise impose on that State's insurers doing business in California.

2. Arguments in favor of combination.

    a. The argument in favor of combination is that a commonly owned group of general and insurance corporations have just as much opportunity and motivation to transfer values between corporate enterprises as do general corporations at large. Thus, the rationale for combined reporting is just as strong as general combined reporting.

    b. Merely because an insurance company's income and apportionment factors are included in a combined report of general corporate taxpayers doesn't impose a tax on the insurance company itself. Thus, if an insurance company were doing business in the state, its apportionment factors would be reflected in the denominator of the apportionment factors, but not in any numerator for income tax purposes. Accordingly, any income that would be otherwise "apportioned" to the insurance company would be untaxed, because the "in lieu" provision of the state would provide that the gross premiums tax would apply "in lieu" of any tax on that apportioned income.[32]

    c. The retaliatory tax statutes may not present a problem. The tax is applied against insurers, not against general corporations that are members of the insurer's affiliated group. Because unitary combination does not directly affect the liability of an insurer (i.e., they remain exempt from the income tax), there is some question whether retaliatory taxes can have any effect, for example, to require retaliatory unitary combination in another state.

3. Assuming that there is no statutory or constitutional prohibition against combination of insurance companies with general corporations, there are some income and apportionment rules that would have to be worked out.

    a. The apportionable tax base. The taxable income of insurance companies for federal law is governed in substantial part by very detailed rules in subchapter L of the Internal Revenue Code.[33] These sections provide special rule for the determination of gross income, expenses, and insurance reserves.

[32] In the *Penn Independent Corp*. case (supra), the Oregon Tax Court found the apportionable income of a unitary consolidated return group should include the income of an insurance corporation even though that corporation was not subject to Oregon's corporate income tax, but instead paid a gross premiums tax. The Tax Court stated: "[i]t is important to remember that including the income of a nontaxable member of a unitary group does not subject that income to taxation by Oregon.

[33] Internal Revenue Code section 801-848.

i. If a state automatically conforms to the federal income tax laws, subchapter L would presumably be included in the determination of the tax base, as well.

ii. However, for a state like California, which incorporates only *certain* Internal Revenue Code provisions, there is no statutory authority for computing the insurance company's net income (included in the apportionable unitary tax base) under those federal provisions.

iii. In that case, would an insurance company's income be taxed only under standard accrual principles (i.e., the "all events test?"[34]) Would this deny an insurance company a deduction for addition to insurance reserves, and allow payment of claims deductions only when all events giving rise to the obligation to pay have been satisfied? Note that the apportionment rules do not affect the computation of the taxpayer's total net income tax base itself.[35]

b. How would the insurance company's denominators be computed? (Recall that the insurance company's numerators would be disregarded in an "in lieu" state; see discussion above).

i. Should the sales factor include only "net premiums," i.e., by subtracting premiums returned to customers (analogous to the sales factor that disregards "returns and allowances" for sales of tangible personal property[36])? Should sales of intangibles be reflected on a net basis, analogous to banks?

ii. Should there be property factor representation for investments of an insurance company analogous to inclusion of loans and credit card receivables in the property factor of banks? Should there be a discount of that value, analogous to the discounted

[34] See section 461, Internal Revenue Code, and the regulations thereunder. Generally, under the accrual method of accounting, a deductible item is generally taken into account for federal income tax purposes in the taxable year in which (1) all the events have occurred that establish the fact of the liability to pay, (2) the amount of the liability can be determined with reasonable accuracy, and (3) economic performance has occurred with respect to the liability.

[35] See, Pierce, *The Uniform Division of Income for State Tax Purposes* (1957) 35 Taxes 747 ("[UDITPA] assumes that the existing state legislation has defined the base of the tax and that the only remaining problem is the amount of the base that should be assigned to the particular taxing jurisdiction."); *Appeal of Crisa Corporation*, 2002-SBE-004, June 20, 2002; *Appeal of CTI Holdings, Inc*., Cal. St. Bd. of Equal., 96-SBE-003, February 22, 1996.

[36] MTC Reg.IV.15(a)(1)(A).

value of loans, when general corporations and financial corporations are combined (see discussion above regarding Cal. Code of Regs. §25137-10). How would the amount of that discount be determined?

iii. Should there be payroll factor representation for so-called "independent agents," or should they be excluded from the payroll factor, as would any other independent contractor?

c. For the few states that tax insurance companies under an income tax (usually with a credit for gross premiums tax, or a credit of income tax against gross premiums tax), presumably there would need to be numerator assignment rules for purposes of apportioning income to the insurance company for imposition of tax.

i. For sales factor purposes, would the standard cost of performance rules apply to assign premium income, or is there a reason to adopt a market based approach (i.e., location of the customer, i.e., commercial domicile or billing address) as is the case for banks and financials? Should the sales factor instead be assigned to the location of risk, analogous to the assignment of interest to the location where a bank's security in real property is? Where would the numerator of the sale factor be located for sales of investment assets?

ii. For property factor purposes, assuming that property factor representation is provided for insurance companies, would the property be assigned to the numerator of the headquarters state, analogous to the financial SINAA rules (see above), or would location of insurance risk be more appropriate?

VII. Conclusion.

As can be seen, there are already significant problems with respect to the apportionment of income of financial corporations, securities dealers, and insurance companies. The potential for combination requires not only that the industry specific apportionment rules for these industries be rationalized, but also that the interactive effects of combination of these entities, as well as combination of these entities with general corporations, be considered. As the effects of financial deregulation began with federal law change in 1999, the combined reporting states should be starting to see some of the issues presented in this discussion in their current audit cycles. How will taxpayers and the states respond? Because of the similarities of these businesses, a piecemeal approach seems shortsighted. Do these issues require a broad multistate regulatory project, similar to the efforts of the MTC to bring uniformity to the apportionment rules for banks and financial corporations?